IN THE SUPREME COURT OF IOWA

No. 16-1974

BEVERLY GARDINER NANCE

Petitioner-Appellant,

v.

IOWA DEPARTMENT OF REVENUE,

Respondent-Appellee.

APPEAL FROM THE IOWA DISTRICT COURT
FOR POLK COUNTY
THE HONORABLE MICHAEL D. HUPPERT, JUDGE

BRIEF OF APPELLEE AND NOTICE OF ORAL ARGUMENT

THOMAS J. MILLER
Attorney General

DONALD D. STANLEY, JR. AT0007606
Special Assistant Attorney General
Email: donald.stanleyjr@iowa.gov

HRISTO CHAPRAZOV AT0010892
Assistant Attorney General
Hoover State Office Bldg., Second Floor
Des Moines, Iowa 50319
Telephone: 515-281-5846
Facsimile: 515-281-4209
Email: hristo.chaprazov@iowa.gov

FINAL BRIEF

Attorneys for Appellee

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Cases **Page(s)**

Rules

Statutes

Administrative Rules

Other Authorities

Iowa Code § 450.2 (2009)

Iowa Code § 633D.9 (2009)

Iowa Code § 633D.11 (2009)

Iowa Code ch. 450

Iowa Code § 450.3(3) (2009)

Seeley v. Seeley, 45 N.W.2d 881 (Iowa 1951)

Iowa Admin. Code r. 701-86.14(2) (2010)

In re Estate of Orlo Shank, No. 93-70-2-0143, 1994 WL 762696 (Iowa Dep't of Revenue & Fin. Nov. 4, 1994)

In re Estate of Spurgeon, 572 N.W.2d 595 (Iowa 1998)

Watrous v. Watrous, 163 N.W. 439 (Iowa 1917)

Estate of Bosch, 387 U.S. 456 (1967)

Estate of Brandon v. Comm'r, 828 F.2d 493 (8th Cir. 1987)

Estate of Hubert v. Comm'r, 101 T.C. (CCH) 314 (T.C. 1993)

Estate of Carpenter v. Comm'r, 52 F.3d 1266 (4th Cir. 1995)

Ahmanson Found. v. United States, 674 F.2d 761 (9th Cir. 1981)

ROUTING STATEMENT

The Department disagrees with Taxpayer's assertion that the Iowa Supreme Court should retain this appeal because it involves "substantial issues of first impression." *See* Appellant's Br. at 4.

Such assertion is in direct contradiction with Taxpayer's argument that the holding of *In re Estate of Van Duzer*, 369 N.W.2d 407 (Iowa 1985) controls the outcome of this case. *See id.* at 5-7, 10.

Resolving the issue presented by this appeal requires "the application of existing legal principles." *See* Iowa R. App. P. 6.1101(3)(a). Iowa law is clear that only property passing from a decedent is subject to inheritance tax and that interested parties cannot by a post-mortem agreement determine to whom property passed from the decedent. *See In re Estate of Bliven*, 236 N.W.2d 366, 371 (Iowa 1975). Therefore, this appeal should be transferred to the Iowa Court of Appeals.

STATEMENT OF THE CASE

The Department agrees with Taxpayer's recitation of the Procedural Background of this contested case.

STATEMENT OF THE FACTS

The Department generally agrees with Taxpayer's recitation of the relevant facts, with the following four clarifications. First, Taxpayer states that "[t]he circumstances surrounding Decedent's designation of Taxpayer as beneficiary of the Accounts are at the

heart of this controversy." *See* Appellant's Br. at 1–2. Decedent's mental capacity and the circumstances surrounding the execution of the change of beneficiary form ("Beneficiary Form") are irrelevant to this appeal because Taxpayer has limited the scope of this appeal to a single legal issue, i.e., whether, under Iowa law, a family settlement agreement controls for inheritance tax purposes. *See id.* at 5.

Second, Taxpayer cites to Exhibit 8, but that exhibit was not admitted in evidence at the contested case hearing. *See id.* at 3.

Third, Taxpayer states that Decedent's "[medical] records indicated that Decedent . . . was incapable of understanding his financial information or the consequences of any changes made." *See id.* It was Dr. Robert Bender's opinion that Decedent did not have sufficient capacity to make financial decisions; the medical records admitted in evidence do not contain such conclusions. Moreover, both the Administrative Law Judge ("ALJ") and the Director of Revenue concluded that Taxpayer did not meet her burden of proof regarding Decedent's alleged incompetence. *See* Proposed Decision at 5–7 & Director's Final Order at 3–4 (App. at 87–89; 92–93). Because Taxpayer did not challenge the agency's

fact-finding on appeal, the district court concluded that it "[wa]s bound by the[] [facts] on judicial review." *See* Ruling on Pet. for Judicial Review at 2 (App. at 97). On appeal to this Court, Taxpayer does not dispute this conclusion. *See generally* Appellant's Br.

Fourth, Taxpayer states she entered into the Family Settlement Agreement ("Agreement") "in good faith to resolve a genuine dispute that she likely would have lost, and not for any purpose of avoiding taxes." *See* Appellant's Br. at 4. Contrary to this statement, however, neither the agency nor the district court made a finding regarding Taxpayer's motives in executing the Agreement. Furthermore, Taxpayer's statement that the Department "does not challenge Beverly's motives [in entering into the Agreement]," *see* Appellant's Br. at 4, is not supported by the record. The Department's position has always been that Taxpayer's motives are "immaterial to determining whether assets from Decedent's [brokerage] [a]ccounts passed to his grandchildren upon his death or by operation of the Agreement." *See* Dep't's Reply to Taxpayer's Resistance to Dep't's Mot. for Summ. J. at 4 (App. at 76).

ARGUMENT

THE IOWA DISTRICT COURT CORRECTLY UPHELD THE AGENCY'S CONCLUSION THAT THE FAMILY SETTLEMENT AGREEMENT HAD NO EFFECT ON TAXPAYER'S INHERITANCE TAX LIABILITY.

A. Preservation of Error.

The Department agrees that Taxpayer preserved this issue for appeal. *See* Appellant's Br. at 1.

B. Standard of Review.

The Department disagrees that the applicable standard of review is de novo. *See* Appellant's Br. at 5. Taxpayer's reliance on *Estate of Bliven* and *Estate of Dieleman v. Department of Revenue, State of Iowa*, 222 N.W.2d (Iowa 1974) is misplaced. Neither case was governed by Iowa Code chapter 17A. Rather, they were both probate cases involving petitions for declaratory judgments and were tried in equity in Iowa district court. *See Estate of Bliven*, 236 N.W.2d at 369; *Estate of Dieleman*, 222 N.W.2d at 460; Iowa Code § 633.33 (1973). While both *Estate of Bliven* and *Estate of Dieleman* involved issues of statutory interpretation and application, this Court must decide whether the Director of Revenue's Final Order was the product of an irrational, illogical, or wholly unjustifiable

application of the relevant law to the facts of this case. *See id.* § 17A.19(10)(m).

Iowa Code section 17A.19(10) controls the judicial review of agency decisions. *Renda v. Iowa Civil Rights Comm'n*, 784 N.W.2d 8, 10 (Iowa 2010) (internal citation omitted). "This court, like the district court, functions in an appellate capacity to correct any errors of law on the part of the agency." *Richards v. Iowa Dep't of Revenue*, 360 N.W.2d 830, 831 (Iowa 1985) (internal citation omitted). The appellate court must "apply the standards of section 17A.19(10) to determine if . . . [it] reach[es] the same results as the district court." *Id.* (internal citation omitted). "[Appellate] review is limited to a determination of whether the district court made errors of law when it exercised its power of review of agency decision under Iowa Code section 17A.19." *McClure v. Iowa Real Estate Comm'n*, 356 N.W.2d 594, 596 (Iowa Ct. App. 1984) (internal citations omitted). "Iowa Code section 17A.19 limits the district court's review to a determination of whether the agency committed any of the errors of law set out in section 17A.19(8) [now section 17A.19(10)]." *Id.* If the appellate court reaches the same conclusions, it affirms the

district court; otherwise, the lower court is reversed. *Iowa Ag Const. Co. v. Iowa State Bd. of Tax Review*, 723 N.W.2d 167, 172 (Iowa 2006).

C. The Family Settlement Agreement Is Not A Taxable Event For Inheritance Tax Purposes.

This issue involves the agency's application of the relevant law to the facts of this case. *See* Ruling on Pet. for Judicial Review at 1 (App. at 96). "Because factual determinations are by law clearly vested in the agency, it follows that application of the law to the facts is likewise vested by a provision of law in the discretion of the agency." *Iowa Ag Const. Co., Inc.*, 723 N.W.2d at 174. Therefore, this Court may "reverse the agency's application of the law to the facts only if . . . [it] determine[s] such application was 'irrational, illogical, or wholly unjustifiable.'" *Id.* (quoting Iowa Code § 17A.19(10)(m)).

Noting that "[Taxpayer] is not challenging the factual findings of the . . . [Department] based on a lack of substantial evidence," the district court concluded that it "is bound by them on judicial review." *See* Ruling on Pet. for Judicial Review at 2 (App. at 97). Therefore, the district court's review of this issue was limited to deciding whether the agency's application of the relevant law to the facts of this

contested case was irrational, illogical, or wholly unjustifiable. *See id.* at 1–2 (App. at 96–97). Applying this standard to the agency's final decision, the district court held, on the authority of *Estate of Bliven*, that the Agreement was not a taxable event for inheritance tax purposes. *See id.* at 7–9 (App. at 102–04). For reasons that follow, this Court must affirm the district court's ruling.

Under Iowa law, only property passing from a decedent is subject to inheritance tax. *See* Iowa Code § 450.2 (2009). Upon Decedent's passing, title to the assets in his brokerage accounts ("Accounts") passed instantaneously from him to Taxpayer pursuant to the contract between Decedent and Edward D. Jones, the registering agency for Decedent's Accounts. *See id.* §§ 633D.9, 633D.11 (2009). Thus, the Accounts' assets were subject to inheritance tax, unless one of the exemptions in Iowa Code chapter 450 applied. *See id.* § 450.3(3) (2009). Although Decedent's estate claimed that Decedent was not legally competent to execute the Beneficiary Form, it ultimately compromised its claim by entering into the Agreement with Taxpayer. Thus, there was no final judicial determination that Decedent did not have the legal capacity to

execute the Beneficiary Form. Indeed, this Form remains a valid legal document today. Had there been such determination, it would have invalidated the Beneficiary Form and changed to whom title to the Accounts' assets passed from Decedent upon his death.

A settlement agreement does not have the same effect, however. *See Seeley v. Seeley*, 45 N.W.2d 881, 884-85 (Iowa 1951) ("[By entering into a settlement agreement, however,] [t]he contracting parties do not determine to whom title passes from decedent."); *see also* Iowa Admin. Code r. 701-86.14(2) (2010). "In legal effect the contracting parties convey title from themselves. . . . The probate court shapes the administration so as to carry out the contract but by no theory or fiction of law does title bypass the heirs or beneficiaries and pass direct from decedent to those designated by the contract." *Id.* at 885. In contrast, had Decedent's estate succeeded in invalidating the Beneficiary Form, title to the Accounts' assets would have passed from Decedent to his grandchildren pursuant to his will. Because a settlement agreement may not determine "to whom property passed from the decedent," however, the Agreement is not a taxable event for inheritance tax purposes. Therefore, the

Department did not err in denying Taxpayer's refund claim. *See In re Estate of Orlo Shank*, No. 93-70-2-0143, 1994 WL 762696, at *3-4 (Iowa Dep't of Revenue & Fin. Nov. 4, 1994) (noting that a settlement agreement may not determine to whom title passed from the decedent and concluding that, because the will was not declared invalid, "the Department correctly denied the inheritance tax refund claim which was based on the settlement agreement rather than on the will").

1. Estate of Bliven *is dispositive.*

For reasons that follow, the district court correctly concluded that *Estate of Bliven* controls the outcome of this contested case. *See* Ruling on Pet. for Judicial Review at 7–9 (App. at 102–04). Indeed, as explained below, the present dispute is analogous—both factually and procedurally—to *Estate of Bliven*. As in this case, the question in *Estate of Bliven* was whether the inheritance tax should be determined according to the distribution of the decedent's assets at the time of the decedent's passing or according to the distribution of such assets as outlined in a court-approved settlement agreement. *See* 236 N.W.2d at 369 ("The question here posed may be thus stated:

Where heirs at law and charitable organizations enter into a court approved will contest avoidance agreement for distribution of an intestate's estate to such heirs and charities in designated proportions, is the share accordingly conveyed to the charities exempt from inheritance tax?"). Also, both cases involve parties unsatisfied with the distribution of the decedents' property in effect at the time of the decedents' passing—the charitable organizations in *Estate of Bliven* stood to receive none of the decedent's property under the laws of intestacy and, in this case, pursuant to the Beneficiary Form, none of Accounts' assets were to be included in Decedent's estate. *Compare In re Estate of Bliven*, 236 N.W.2d at 368 with Ex. 7 (App. at 27) (the Beneficiary Form listing Taxpayer as the sole surviving beneficiary of Decedent's Accounts). The aggrieved parties in both cases, i.e., the charitable organizations and Decedent's estate, challenged the decedents' capacity to direct the distribution of their property that was in effect at the time of their passing. *Compare In re Estate of Bliven*, 236 N.W2d at 368 with Ex. 1 ¶¶ 8–12 (App. at 57 ¶¶ 8–12).

Recognizing the uncertainty inherent in all litigation, however, both the charitable organizations and Decedent's estate ultimately decided to compromise their claims by entering into settlement agreements, whereby they received only a portion of the decedents' property that they would have otherwise been entitled to had they pursued the competency issue to a favorable judicial determination. *Compare In re Estate of Bliven*, 236 N.W2d at 368 (the charitable organizations agreeing to receive only one half of the decedent's estate, even though a judicial determination that the decedent did not have the requisite capacity to revoke her will would have entitled the charities to a substantially larger portion of her estate) with Ex. C at 2 ¶ 1 (App. at 70 ¶ 1) (Decedent's estate agreeing to receive only one half of the Accounts' assets, even though a final determination that Decedent was incompetent to execute the Beneficiary Form would have entitled his estate to all of the Accounts' assets). Following the execution of the settlement agreements, the decedents' estates filed inheritance tax returns claiming that the property passing to the charitable organizations in *Estate of Bliven* and to Decedent's grandchildren in this case was exempt from inheritance tax.

Compare In re Estate of Bliven, 236 N.W.2d at 368 with Ex. A (App. at 5–22). The Iowa Supreme Court in *Estate of Bliven* ruled in favor of the Department, noting that "[the] inheritance tax exemption statute [at issue] never came into play as to any right in . . . [the decedent's] estate indirectly acquired . . . by these charitable organizations . . . [because the] property rights acquired by the two charities passed to them only by assignment from [the] decedent's heirs, separate and apart from her death." 236 N.W.2d at 371 (internal citations omitted). The same ruling is warranted in this case.

The holding in *Estate of Bliven* rests on the following two well-established propositions. First, Iowa's inheritance tax is levied only on property passing from a decedent; therefore, section 450.9, the inheritance tax exemption provision for lineal descendants that Taxpayer relies on, may only exempt from inheritance tax property passing from a decedent. *See Estate of Bliven*, 236 N.W.2d at 371; *see also id.* § 450.2 (2009) (providing that real and tangible personal property in Iowa and intangible personal property owned by a decedent domiciled in Iowa "pass[ing] from the decedent owner in

any manner described in this chapter" is subject to inheritance tax). Second, interested parties cannot, by agreement, determine to whom property passed from a decedent. *See Estate of Bliven*, 236 N.W.2d at 371; *see also Seeley*, 45 N.W.2d at 884–85 ("[By entering into a settlement agreement, however,] [t]he contracting parties do not determine to whom title passes from decedent. . . . In legal effect the contracting parties convey title from themselves. . . . The probate court shapes the administration so as to carry out the contract but by no theory or fiction of law does title bypass the heirs or beneficiaries and pass direct from decedent to those designated by the contract."). Both of these legal principles apply to this contested case, and, for that reason, this Court must conclude that *Estate of Bliven* is dispositive.

2. Estate of Van Duzer *is inapposite.*

Taxpayer contends that *Estate of Van Duzer*, not *Estate of Bliven*, is dispositive as to her inheritance tax liability. *See* Appellant's Br. at 5—7. For reasons that follow, however, this Court must affirm the district court's conclusion that "the [D]epartment was correct in not following *Van Duzer*." *See* Ruling on Pet. for Judicial

Review at 10 (App. at 105). Contrary to Taxpayer's assertion, *Estate of Van Duzer* did not hold that "the decedent's property *passed* to his spouse under the family settlement agreement . . . and thus qualified for a marital exemption." *See* Appellant's Br. at 6. Although *Estate of Van Duzer* held that the payment received by the decedent's surviving spouse pursuant to a settlement agreement qualified for the spousal inheritance tax exemption, *see* 369 N.W.2d at 409–10, such holding did not turn on the fact that the interested parties had entered into the settlement agreement. Indeed, this Court observed that "the settlement agreement under which payment was made to the surviving spouse [w]as a tripartite agreement whereby the trustee agreed to return $106,500 to the estate, and the executor agreed to pay an identical sum to the surviving spouse in satisfaction of her distributive share." 369 N.W.2d at 410. In fact, the Court noted that it would have been "better . . . if separate checks were issued for this purpose, a deposit to the estate account had been documented and a court order had been obtained authorizing the payment of a distributive share in the sum agreed to in the settlement," thus clarifying that the decedent's surviving spouse did not receive the

funds at issue ($106,500) pursuant to the settlement agreement, but from the decedent by claiming against his will. *See id.* That is the difference between cases such as *Estate of Bliven* and this appeal, on the one hand, and *Estate of Van Duzer*, on the other. *See id.* While the decedent's wife in *Estate of Van Duzer*, as his surviving spouse, was entitled to claim against his estate, Taxpayer and the beneficiaries of Decedent's estate in this case could not make an election to take against Decedent's will, and neither could the two charities in *Estate of Bliven*. *See id.* Indeed, this distinction is precisely why the Iowa Supreme Court concluded that "the cited cases [cited by the Department, one of which was *Estate of Bliven*,] [we]re clearly distinguishable from the . . . [*Estate of Van Duzer*] case." *See id.*

Estate of Bliven and *Estate of Van Duzer* do not contradict one another because they do not apply to the same fact patterns. The linchpin of the *Estate of Van Duzer* holding is the fact that the claimant in that case—the decedent's surviving spouse—was "entitled to a distributive share [from the decedent's estate] by reason of her election to take against the will." *See* 369 N.W.2d at 410. Specifically, unlike a settlement agreement, a spousal election to take

against the decedent's will transfers title over such distributive share from the decedent to the surviving spouse. *See In re Estate of Spurgeon*, 572 N.W.2d 595, 598 (Iowa 1998) ("The authorities are clear as to the effect of an election by a surviving spouse: a choice to take against the will is a genuine election which nullifies gifts to the surviving spouse in the will but leaves the will to be carried out as to the other devisees as nearly as may be done."). In effect, a spousal election to take against the will would invalidate any provisions in the will devising property to the surviving spouse. *See Watrous v. Watrous*, 163 N.W. 439, 443 (Iowa 1917) ("If the survivor elects not to consent to the provisions of the will, the effect of such election is to render any provision made by the will, for the benefit of such survivor, inoperative, and the survivor will take the distributive share provided by law."). In contrast, although the Agreement in this case effectively distributed Decedent's property in a manner contrary to the Beneficiary Form (by allocating to Decedent's grandchildren a bigger portion of Decedent's property than what he provided for in his will), it did not invalidate any provisions of such will. For these reasons, *Estate of Van Duzer* is inapposite.

3. *This Court Need Not Adopt Federal Estate Tax Jurisprudence; In Any Event, Federal Law Does Not Support Taxpayer's Position.*

Taxpayer urges that this Court adopt the four-prong test for recognizing family settlement agreements for federal estate tax purposes. *See* Appellant's Br. at 9 (citing *Estate of Bosch*, 387 U.S. 456 (1967); *Estate of Brandon v. Comm'r*, 828 F.2d 493 (8th Cir. 1987); & *Estate of Hubert v. Comm'r*, 101 T.C. (CCH) 314 (T.C. 1993)). Taxpayer, however, also contends that "[t]he facts of the present matter fit squarely into those of . . . *Van Duzer*." *See id.* at 10. Despite arguing that this appeal falls under the *Estate of Van Duzer* holding, Taxpayer nevertheless advocates for the adoption and application of federal estate tax jurisprudence. Thus, Taxpayer effectively concedes that *Estate of Van Duzer* does not control the outcome of this appeal.

Regardless, as explained in more detail below, federal law is unavailing. Taxpayer asserts that federal courts and the Internal Revenue Service ("IRS") "recognize family settlement agreements for estate and gift tax purposes if the agreement represents a *bona fide recognition* of the parties' *enforceable rights*." *See* Appellant's Br. at 10 (citing 26 C.F.R. § 20.2056(e)-2(d)(2) [now §20.2056(c)-2(d)(2)]).

Taxpayer omits an important part of the cited federal regulation, however. In defining when an interest in property passes from a decedent to his or her surviving spouse within the meaning of 26 U.S.C. section 2056(a), the regulation states, in relevant part, as follows:

> If as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender [w]as a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate.
>
> . . . .
>
> If the assignment or surrender was . . . pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse.

Id. § 20.2056(c)-2(d)(2). The principles set forth in this regulation underpin the holdings of *Estate of Hubert* and *Estate of Brandon*.

In *Estate of Brandon*, following the decedent's passing, his surviving spouse "filed an election to take against . . . [his] will." *See* 828 F.2d at 495. Her election spurred litigation, and after several months of negotiations, the interested parties entered into a settlement agreement, whereby the surviving spouse agreed to accept

the payment of a certain sum "in return for a full release of all claims she held against [the] decedent's estate and the other parties involved." *Id.* When the decedent's estate filed its federal estate tax return, it claimed the full settlement amount as a marital deduction under 26 U.S.C. § 2056(a). *See id.* Only "interest[s] in property . . . pass[ing] . . . from the decedent to his surviving spouse" qualify for the federal estate tax marital deduction. *See id.* § 2056(a). The IRS Commissioner, however, allowed only a portion of this deduction, and the estate sued in the United States Tax Court. *See Estate of Brandon*, 828 F.2d at 495. The Tax Court concluded that the estate was entitled to deduct the full payment amount because "the [settlement] agreement was made in good faith as the result of arm's-length negotiations." *See id.* at 496 (quotation marks omitted).

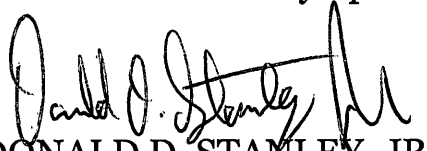
On appeal, the Eighth Circuit reversed and remanded the case to the Tax Court, noting that the issue of deductibility turned not on whether the settlement agreement was negotiated in good faith, but on "the enforceability of . . . [the surviving spouse's] dower claims against the estate under state law at the time the settlement was reached." *See id.* at 499; *accord Estate of Carpenter v. Comm'r*, 52

F.3d 1266, 1273 (4th Cir. 1995) ("[T]he enforceability of a widow's rights is to be determined based on her claims existing against the estate at the time the settlement was reached. Therefore, the proper focus is on the rights a widow received under the terms of the testamentary trust, not on any subsequent rights she may have received from the settlement agreement itself." (internal citations and quotation marks omitted)) & *Ahmanson Found. v. United States*, 674 F.2d 761, 774 (9th Cir. 1981) ("[T]he test of 'passing' for estate tax purposes should be whether the interest reaches the spouse pursuant to state law, correctly interpreted-not whether it reached the spouse as a result of a good faith adversary confrontation."). Similarly, in *Estate of Hubert*, the United States Tax Court noted that it was not bound by the settlement agreement in determining whether the decedent's surviving spouse had any enforceable rights in the decedent's estate. *See* 101 T.C. (CCH) at 319-20. Thus, *Estate of Brandon* and *Estate of Hubert* stand for the proposition that payments pursuant to a settlement agreement qualify for the federal estate tax marital deduction only if those payments were made in recognition of the surviving spouse's enforceable rights in the deceased spouse's estate under state law. Only in those instances

are the payments deemed "interest in property which passes or has passed from the decedent to his surviving spouse." *See id.* § 2056(a). Therefore, *Estate of Brandon* and *Estate of Hubert* support the Department's position insofar as they hold that a beneficiary of a decedent's estate receiving property pursuant to a settlement agreement does not take such property from the decedent, unless the beneficiary has enforceable rights in the decedent's estate under state law that arose independent of such settlement agreement.

CONCLUSION

This Court must affirm the district court's ruling holding that the Agreement had no effect on Taxpayer's inheritance tax liability. The agency's final decision was not based on an irrational, illogical, or wholly unjustifiable application of the law to the facts of this contested case. Therefore, the district court correctly upheld the agency's final decision.



DONALD D. STANLEY, JR. AT0007606
Special Assistant Attorney General
Hoover State Office Bldg., Second Floor
Des Moines, Iowa 50319
Telephone: 515-281-5846
Telefax: 515-281-4209
E-Mail: donald.stanleyjr@iowa.gov

HRISTO CHAPRAZOV AT0010892
Assistant Attorney General
Hoover State Office Bldg., Second Floor
Des Moines, Iowa 50319
Telephone: 515-281-5846
Facsimile: 515-281-4209
E-Mail: hristo.chaprazov@iowa.gov

Attorneys for Iowa Department of Revenue

NOTICE OF ORAL ARGUMENT

The Department disagrees that an oral argument is necessary. *See* Appellant's Br. at 14. The appeal may be deemed submitted on the briefs. However, in the event Taxpayer is granted oral argument, the Department respectfully requests an opportunity to be heard as well.

CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitation of Iowa R. App. P. 6.903(1)(*g*)(1) or (2) because:
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